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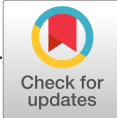
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Company purpose and profit need not be in conflict if we ‘grow the pie’

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1 | A CRISIS OF CONFIDENCE IN CAPITALISM

An apparent consensus exists amongst politicians, citizens, and even executives themselves – at both ends of the political spectrum and in many countries – that capitalism isn’t working for ordinary people (see e.g. Frank, 2019; Ignatius, 2019; Kassam & Mathieu-Léger, 2016; Steverman, Merrill, & Lin, 2018).

The financial crisis of 2008 is said to have cost nine million Americans their jobs and ten million their homes (Puzzanghera, 2018; Shalby, 2018). Even though the US economy has recovered, the gains seem largely to have gone to bosses and shareholders, while ordinary incomes have stagnated. In a wider context, it is salutary to reflect that, in 2018, just 26 tycoons owned the same wealth as the 3.8 billion poorest citizens in the world (Oxfam, 2019, 2020).

Corporations affect not only people but also the planet. The environmental costs created by business are estimated at \$4.7trn per year (Trucost, 2013, p. 9). Notable examples are the Deepwater Horizon disaster of 2010 which spilt five million barrels of oil into the sea, and Volkswagen’s dodging of emissions tests which may have contributed to an estimated 1,200 deaths in Europe alone (Chu, 2017).

People, and politicians representing them, are fighting back. The reaction varies – Occupy movements, Brexit, electing populist leaders, restricting trade and immigration, and revolting against CEO pay. But the sentiment is the same everywhere: ‘they’ are benefiting at the expense of ‘us’.

Radical calls to reform capitalism drum up significant support but risk throwing the baby out with the bathwater and ignore the positive role that profit-making businesses can play in society. A host of successful companies design products that transform customers’ lives for the better, provide employees with a healthy and enriching workplace, and help preserve the environment for future generations. Merck’s drug ivermectin has substantially reduced river blind-

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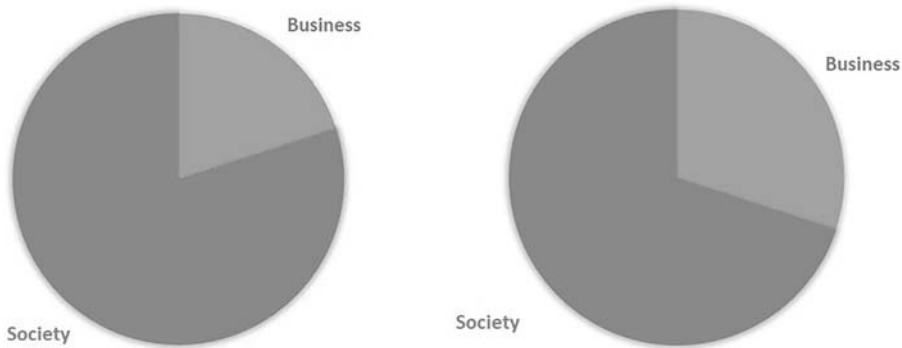


FIGURE 1 Pie-splitting

ness worldwide (Turner, Walker, Churcher, & Basanez, 2014); Vodafone's mobile money service M-Pesa has lifted 200,000 Kenyans out of poverty (Suri & Jack, 2016); and Google's maps, search engines, and shared documents make millions of lives easier each day. Moreover, successful businesses generate profits. Profits aren't evil 'value extraction' but serve a crucial role in society – providing returns to parents saving for their children's education, pension schemes investing for their retirees, or insurance companies funding future claims.

Viewing business as 'them' and society as 'us' is an example of what can be termed the 'pie-splitting' mentality. Its adherents see the value that a company creates as a fixed pie. It follows that any slice of the pie taken by the firm and its shareholders reduces the slice enjoyed by society. In this view, the best way to increase society's take is to straitjacket business so that it doesn't make too much profit. Sadly, rather too many CEOs also display pie-splitting thinking – but the other way round. They think that the best way to increase profit is to reduce society's slice, by price-gouging customers or exploiting workers (Figure 1).

In the pie-splitting mentality, business and society are enemies. And the battle they've been fighting has been around for centuries. In the mid-nineteenth century, Karl Marx wrote about the struggle between capital and labour. Since then, we've seen a pendulum swing back and forth between business and society. Think of the late nineteenth-century American robber barons who created giant monopolies such as Standard Oil; policymakers responded by breaking some up. Or recall the peak of labour unionism in the 1970s, which was followed by legislation that helped to cause unionism's sharp decline. Or the rise of big banks in the early twentieth century which culminated in the 1929 financial crisis and their regulation by the Glass-Steagall Act of 1933 – itself partially repealed since the 1980s, contributing to another crisis in 2007. Unless we can come up with another way, this movie will keep on being replayed indefinitely.

2 | A NEW APPROACH

But another way does exist. By applying a radically different approach to business, companies can create both profit for investors *and* value for society.

This new approach is the 'pie-growing' mindset, which stresses that the pie is not fixed (Figure 2). By investing in stakeholders, a company doesn't have to reduce the investors' slice, as some CEOs assume, but grows the pie, ultimately benefiting investors. A company may improve working conditions out of genuine concern for its employees, yet these employees become more motivated and productive. A company may develop a new drug to solve a public

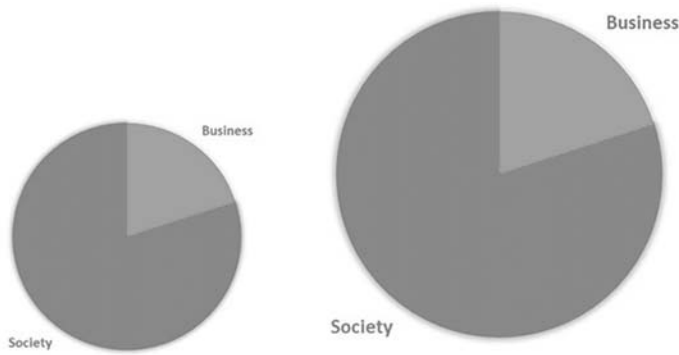


FIGURE 2 Pie-growing

health crisis, without considering whether those affected are able to pay for it, yet ends up successfully commercialising it. A company may reduce its emissions far beyond the level that would lead to a fine, due to its sense of responsibility to the environment, yet benefit because customers, employees, and investors are attracted to a firm with such values. The pie can grow, to everyone's benefit. Conversely, a company that concentrates exclusively on short-run profit at the expense of stakeholders may end up shrinking the pie.

Under the pie-growing mentality, a company's primary goal is to serve society rather than generate profits. At first glance, this approach seems completely heretical to the gospel preached in Milton Friedman's (1970) famous article titled 'The Social Responsibility of Business is to Increase its Profits'. However, that article has been frequently misportrayed and misquoted. Critics of capitalism like to cite it as it seems to advocate a particularly narrow-minded view of capitalism – one that disregards stakeholders and seeks only to feed investors' greed. By caricaturing the current model of capitalism, critics can then push their own ideas of how capitalism should be reformed, and it's not difficult to argue that their philosophy of business is superior when the alternative has been presented as a straw man.

To have a serious conversation about how businesses should be run, it's essential to recognise that the Friedman view is far more nuanced than it's commonly taken to be. It argues that a company should focus exclusively on profits because the only way it can deliver profits – at least in the long term – is by serving society. Thus, profit maximisation is socially desirable as it leads companies to invest in their stakeholders. Friedman (1970, p. 5) wrote: "... it may well be in the long-run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees."

Even though the Friedman value of shareholder value maximisation is much more enlightened than commonly believed, the pie-growing mentality remains fundamentally different. A shareholder-focused company will indeed still invest in stakeholders – but only if it calculates that such an investment will increase profits by more than the cost of the investment. Indeed, comparing costs and benefits is how finance textbooks argue companies should decide whether or not to undertake investment.

However, real life isn't a finance textbook. In practice, it's very difficult to calculate the future pay-off of any investment. In the past, this was easier when investments were in *tangible* assets – if you build a new factory, you can estimate how many new widgets the factory will produce and how much you can sell them for. But most of the value of a twenty-first-century firm comes from *intangible* assets, such as brand and corporate culture. If a company improves



working conditions, it's impossible to estimate how much more productive workers will be, and how much more profit this greater productivity will translate into. The same is true for the reputational benefits of a superior environmental record. A company that's free from the shackles of having to justify every investment by a calculation will invest more and may ultimately become more profitable.

This new approach to business is the subject of my new book, *Grow the Pie: How Great Companies Deliver both Purpose and Profit* (Edmans, 2020), published 50 years after Friedman's famous article. I wrote this book out of concern for the growing polarisation between business and society. In the face of this conflict, it is a fundamentally optimistic book. Yet this optimism is not based on blind hope, but on rigorous evidence that this approach to business works – across industries and for all stakeholders – and on an actionable framework to turn it into reality.

Let's indeed turn to the evidence. The idea that business and society can benefit simultaneously might seem to be too good to be true. However, rigorous evidence suggests that purposeful companies that treat their stakeholders well deliver superior long-term returns to investors. For example, one of my own studies (Edmans, 2012) shows that companies with high employee satisfaction outperformed their peers by 2.3–3.8 per cent per year over a 28-year period. That's 89–184 per cent compounded. I did further tests suggesting that it's employee satisfaction that leads to good performance rather than the reverse. Other studies find that customer satisfaction, environmental stewardship, and sustainability policies are also associated with higher stock returns.

So creating value for stakeholders isn't just a worthy ideal – it is often good business sense. When I speak to practitioners on the importance of purpose, I'm introduced as a professor of finance, and the audience often thinks they've misheard. Finance departments are frequently the enemy of purposeful business, which believes that it's simply a distraction from creating profits. This might be true in the short term, but the long-term evidence shows that any finance department with this mindset is failing at its job. The positive relationship with long-term returns also means that it's in companies' own interest to transform the way they do business and take very seriously their impact on society. It's urgent that they do. Otherwise, anti-business regulations will be enacted, and customers and workers will switch to competitors whose values they share. Serving society isn't an optional extra to be confined to a Corporate Social Responsibility department offering 'community events' and supporting a few charities, but should be fundamental to how a business is run.

3 | A TRANSFORMATIVE SHIFT IN THINKING

The pie-growing mentality shifts our thinking on some of the most controversial aspects of business. First, it transforms what leaders' and enterprises' responsibilities are, and what society should hold them accountable for. We often name and shame companies which engage in *errors of commission* – actions seen as pie-splitting, such as making what we see as too much profit. But high profits may be a by-product of serving society. Instead, we should hold businesses accountable for *errors of omission* – spurning opportunities to grow the pie through inaction. For example, Kodak failed to invest in digital cameras and ultimately went bankrupt. Yet it's rarely seen as a corporate governance failure because investors didn't profit – but that's of no consolation to the 150,000 workers who were made redundant. In this new way of thinking, an irresponsible company is one that shrinks the pie or fails to grow it, harming everyone.

Second, the pie-growing mentality changes our view on how to reform executive pay (Edmans, 2019). The level of CEO pay is perhaps the single most-cited piece of evidence that business is out of touch with society. In the US, the average S&P 500 CEO earned \$14m in 2017, 361 times what the average employee earned. The idea is that, if the CEO wasn't so greedy, his or her pay could be redistributed to colleagues or invested. But that's the pie-splitting mentality. The amount that can be reallocated through redistributing the pie is tiny. The median equity value in the S&P 500 is \$22bn. \$14m is only 0.06 per cent of the pie – far smaller than the 2.3–3.8 per cent that can be created by growing the pie through improving employee satisfaction.

Moreover, just like high profits, high pay can be a by-product of creating value. It's fair for CEOs to be paid like owners – to own a long-term share in the business, so that they're on the hook if it underperforms. But the flip side is that, if they grow the long-term stock price, they'll automatically be rewarded as their shares will be worth more. For example, Disney's Bob Iger was criticised for earning \$66m in fiscal 2018, but the market value of Disney had risen by 578 per cent in his four years at the helm, and 70,000 jobs had been created (Sonnenfeld, 2020). So we shouldn't criticise high CEO pay without first asking whether it results from pie-growing or pie-splitting.

And that's where there is indeed major room for reform. Some CEOs aren't paid like long-term owners. They're instead given bonuses based on short-term targets – and so it's indeed possible for them to earn millions by exploiting workers and customers. So the solution isn't so much to change the *level* of pay, even though this might win the most headlines, but its *structure* – to move away from short-term targets and pay CEOs with shares that they can't sell for (say) five to seven years. Giving CEOs long-term incentives rewards them for pie-growing and discourages pie-splitting. Importantly, bosses should continue to hold shares after retirement, to ensure that their horizon extends beyond their tenure. Moreover, shares should be awarded to all employees, to ensure that everyone benefits from pie-growth. If the company does well, it's not just due to the CEO.

Third, the pie-growing mentality shifts our thinking on investors. Investors are often viewed as nameless, faceless capitalists who extract profits at the expense of society. One author (Georgescu, 2017) has claimed that they are “like terrorists who manage through fear and strip the company of its underlying crucial assets, ... extracting cash out of everything that would otherwise generate long-term value”. This is the sort of thinking that has led politicians in both the UK and the US to propose restrictions on investor rights. But such views aren't backed up by the evidence. Rigorous studies show that, while shareholder activism does indeed increase profits, this doesn't arise from pie-splitting but from pie-growing – improved productivity and innovation, which in turn benefits society.

Investors are not ‘them’; they are ‘us’. As mentioned earlier, they include ordinary citizens saving for retirement, or mutual funds or pension funds investing on their behalf. Policies that suppress investors will not only make companies less purposeful and less productive, but also harm citizens. Investors aren't the enemy, but allies in growing the pie. Any serious proposal to reform business should place investor engagement front and centre.

4 | PUTTING IT INTO PRACTICE

So how does a company actually grow the pie? The starting point is to define its purpose – why it exists, its reason for being, and the role that it plays in the world. A purpose might be to



develop medicines that transform citizens' health; to provide an efficient rail network that connects people with their jobs, family, and friends; or to manufacture toys that entertain and educate children.

Importantly, in this view a company's purpose cannot be to earn profits – instead, profits are a by-product of serving a purpose. This is similar to the way in which an individual's vocation is not to earn a salary; instead, he or she aims to earn a salary by choosing an enjoyable and stimulating career. Equally importantly, a purpose should be focused. Many companies have broad purpose statements, such as 'to serve customers, colleagues, suppliers, the environment, and communities while generating returns to investors', because they sound aspirational. But a purpose that tries to be all things to all people offers little practical guidance because it sweeps the harsh reality of trade-offs under the carpet. Leaders need to make tough decisions that benefit some stakeholders at the expense of others. For example, closing a polluting plant helps the environment but hurts employees. A focused purpose statement highlights which stakeholders are first among equals to guide such a trade-off.

And evidence highlights the criticality of focus. Companies that do well on environmental, social, and governance dimensions across the board don't beat the market. But those that do well on only dimensions material to their business – and scale back on others – do significantly outperform. My book introduces three principles (the principle of multiplication, the principle of comparative advantage, and the principle of materiality) to provide practical guidance on which investments in stakeholders a company should make, and when it should show restraint. This balance is critical. Some leaders misinterpret the call to 'serve society' as an imperative to invest as much as possible, and many politicians advocate such behaviour. But there are many cautionary tales of companies imploding through overinvestment, Daewoo being a particularly prominent one. In 1998, while other Korean conglomerates were cutting back after the financial crisis, Daewoo bought 14 new businesses, despite losing US\$458m that year. The following year, with debts of \$50bn, Daewoo was about to go bankrupt and had to be broken up.

Of course, purpose must go beyond a mere statement and must be put into practice. The book discusses five tools with which a company can do so – aligning its strategy, operating model, culture, reporting, and governance. It also stresses the role of investors in stewarding a company's purpose – holding CEOs to account for embedding it throughout the organisation, and providing an independent sounding board on long-term issues. I provide a practical guide for how investors can undertake stewardship effectively, and how the relationships between different players in the investment industry – asset managers, asset owners, investment consultants, and proxy advisors – can be reformed from the transactional to the trusted, in turn providing the long-term context necessary for stewardship to thrive.

And ordinary citizens have a major part to play too. The popular narrative is that corporations are so large that citizens are powerless to shape them. But I stress how citizens – in their roles as employees, customers, and investors – enjoy *agency*: their capacity to act independently and influence their environment, rather than being acted upon. One source of agency is the power to put their time and money into companies that reflect what they would like to see in the world, and walk away from others. Customer boycotts for allegedly non-purposeful behaviour are arguably more powerful than ever before due to social media, as shown by the #boycottvolkswagen and #DeleteUber campaigns. In the modern firm, human (rather than physical) capital is more important than ever before, and departures of key employees severely damage a company's competitiveness.

5 | CONCLUSION: A COLLABORATIVE EFFORT

So it's not business *or* society – it's business *and* society. This observation gives us great hope, but also great responsibility. Not only can all stakeholders benefit from a growing pie, but it's also their duty to work together to grow the pie. When they do so, bound by a common purpose and focused on the long term, they create shared value in a way that enlarges the slices of everyone – shareholders, workers, customers, suppliers, the environment, communities, and taxpayers. Evidence presented in the book suggests that visionary leaders can transform a company, growing the pie for the benefit of all. Engaged shareholders can intervene in a failing firm, growing the pie for the benefit of all. A motivated workforce can innovate from the bottom up, growing the pie for the benefit of all.

Importantly, an approach to business driven by purpose is likely to end up more profitable in the long term than by attempting to maximise shareholder value. So it is one that leaders should voluntarily embrace, even in the absence of public mistrust or threats of regulation. Creating social value is neither defensive nor simply 'worthy' – it is good business. The evidence, not wishful thinking, leads to this conclusion: to reach the land of profit, follow the road of purpose.

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